No. 15229

In the United States Court of Appeals for the Ninth Circuit

STEPHEN G. ACHONG, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

CHARLES K. RICE,
Assistant Attorney General.

ELLIS N. SLACK,
ROBERT N. ANDERSON,
HELEN A. BUCKLEY,
Attorneys,
Department of Justice,
Washington 25, D. C.

INDEX

CITATIONS

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OPINION BELOW

The memorandum opinion of the Tax Court has not been officially reported. (R. 42-48.)

JURISDICTION

This petition for review (R. 49-50) involves federal income taxes for the taxable years 1946 and 1947. On March 14, 1951, the Commissioner of Internal Revenue mailed to the taxpayer notice of deficiencies in income taxes in the total amount of $11,905.45. (R. 11-15.) Within 150 days thereafter and on April 2, 1951, the taxpayer filed a petition with the

Tax Court for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 3-15.) The decision of the Tax Court was entered March 27, 1956, and served March 29, 1956. (R. 48.) The case is brought to this Court by a petition for review filed June 26, 1956. (R. 49-50.) Jurisdiction is conferred in this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court erred in holding that income realized from the sale of taxpayer's subdivided homestead land constituted ordinary income rather than capital gain.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions*—As used in this chapter—

(1) [as amended by Section 151(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, * * * or real property used in the trade or business of the taxpayer.

* * * *

(26 U.S.C. 1952 ed., Sec. 117.)

STATEMENT

The facts as found by the Tax Court (R. 42-46) were nearly all stipulated (R. 18-27, 42) and may be summarized as follows:

The taxpayer, a citizen of the United States, is a resident of Honolulu, Territory of Hawaii. (R. 42.) He was employed as a cashier by a meat market from 1914 until his retirement in 1950. (R. 43.)

In 1923 the taxpayer was issued a land patent deed to 11.55 net acres of Government land at Halekou, Territory of Hawaii. (R. 19, 43.) In 1915 the taxpayer erected a dwelling on the homesteaded land and has since occupied the dwelling as his home. From time to time until 1946 the taxpayer leased under short-term agreements portions of the land to various tenants for farming purposes. He has never owned any other real estate. (R. 43.)

In 1946 Samuel W. King, a real estate broker, discussed with the taxpayer the sale of his homestead property, and on June 27, 1946, a written agreement was entered into between them. The agreement describes King as "a licensed real estate broker experienced in matters relating to sales of real estate." It provides that the taxpayer grant to King the exclusive right, power, and authority to prepare for sale and to sell the taxpayer's 11.55 acres. (R. 43.)

Under the terms of the agreement King was to hire and supervise surveyors and contractors as needed for preliminary planning and for putting the property in condition for sale in accordance with any approved plan of subdivision, the final plan of subdivision to be subject to taxpayer's approval. Any plan of improvement was likewise subject to taxpayer's approval as to cost. (R. 43.)

King was to be reimbursed by taxpayer for all expenses of preparing the property for sale, including without limitation the cost of surveying, mapping, improving the property and perfecting title. King was to pay all costs of promotion, advertising and all other costs necessary for the sale. (R. 43-44.)

The agreed sales price was to be not less than an average of 25 cents per square foot, the final prices and terms of sale to be agreed upon. King was to receive 10 per cent commission of the gross sale and 2-1/2 per cent of monthly payments on account of sales on terms other than for cash. (R. 44.)

King was to keep complete records and books of account which were to be open to taxpayer's inspection. (R. 44.)

Pursuant to the agreement, King prepared a plan of proposed subdivision which was approved by the taxpayer. On August 1, 1946, the City Planning Commission of the City of Honolulu gave preliminary approval and on January 15, 1948, gave final approval to the plan of subdivision. (R. 44.)

On October 22, 1946, King, with the approval of the taxpayer, entered into a contract with the Paul Low Engineering & Construction Company for the construction of the necessary improvements. Costs of the survey, subdivision, construction and file plans, and final staking out were charged and paid for separately. Between November 25, 1946, and February 17, 1947, the engineering company billed to

King and was paid the aggregate amount of $32,000. The charges for surveying, etc., paid by King totaled $3,000. All these payments were charged to the account of the taxpayer on the books of King. (R. 44-45.)

The taxpayer reserved lots 16, 32 and 33. Lot 16 included the dwelling occupied by taxpayer. Lots 32 and 33 were reserved for future business use. (R. 45.) All the 30 remaining lots were sold. (R. 22.)

King prepared forms to be used in connection with the sale of lots. These forms included a deposit receipt and contract, deed and mortgage. During the period July 18, 1946, to November 19, 1946, deposit receipt and contract forms were executed by purchasers for the 30 lots offered for sale. King received all payments, processed all papers, and made all disbursements. He made appropriate entries in taxpayer's account and rendered periodic statements to taxpayer. (R. 45.)

All sales were made by King without advertising of any kind and no "For Sale" signs were erected on the property. King, however, maintained a real estate office which indicated he had property of the type here in question for sale. All the lots were sold through the activities of King either by contacting persons whom he believed to be prospective purchasers or by suggesting to persons contacting him that the lots were for sale. On occasion prospective purchasers contacted taxpayer who referred them to King. Taxpayer took no part in negotiating any sales. (R. 45.)

The lots in question were lands held by taxpayer primarily for sale to customers in the ordinary course of his trade or business, and the gain realized from the sales in the taxable years involved is taxable as ordinary income. (R. 46.)

In his returns for the years 1946 and 1947 taxpayer elected to return the gains from the sale of lots on the installment basis. The gain realized in 1946 was $35,199.48, and in 1947 was $6,504.39, 50 percent of which was taken into account as long term capital gain. The Commissioner of Internal Revenue determined that the total gain realized in the respective taxable years was ordinary income (R. 45-46) and, accordingly, mailed to the taxpayer notice of deficiencies in the total amount of $11,905.45, of which $11,721.41 is here in dispute (R. 18). The taxpayer timely petitioned the Tax Court for a redetermination (R. 3-15), and after trial based on the stipulation of the parties and testimony of the taxpayer, the Tax Court entered a decision in favor of the Commissioner (R. 48). It is from this decision that the taxpayer petitions this Court for review. (R. 94-50.)

SUMMARY OF ARGUMENT

Whether or not the taxpayer is entitled to report as capital gain the income realized by him from the sale of his subdivided homestead property depends upon whether or not such property is a capital asset as set forth by Section 117(a) of the Internal Revenue Code of 1939. That section excludes from the definition of capital asset that "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

The finding of fact by the Tax Court that the taxpayer's subdivided real estate was held for sale to customers is amply supported by the evidence and by the holding of this Court in *Richards* v. *Commissioner*, 81 F. 2d 369.

While the taxpayer conducted his business through an agent, he maintained control over the actions of the agent in several important aspects: he had a right to approve any final plan of subdivision both as to substance and cost; there had to be agreement between them upon final prices and terms of sale; books of account were to be open to taxpayer's inspection; and periodic statements were to be rendered to the taxpayer. The taxpayer was to reimburse the agent for all expenses of preparing the property for sale, including cost of surveying, mapping and improving the property and perfecting title.

Although the property was not originally purchased for subdividing and sale to customers, it was so held at the time immediately prior to the sale and it is this latter time which is determinative as to whether or not the property was a capital asset. By his actions in subdividing and improving his property the taxpayer went into the business of selling lots. The asserted fact that it was not necessary for the taxpayer or his agent to put on a hard selling campaign does not change the situation, and it should be noted that the agent had a real estate office which indicated in itself that he had property of this type for sale.

The taxpayer could possibly have sold his property without any improvements and without subdividing it and received capital gain treatment thereon. But he chose instead to substantially improve and subdivide the property in order to reap the benefits of increased selling prices. By selecting this method of disposal the taxpayer submitted the property to customers in the ordinary course of his trade or business. Therefore he is not entitled to capital gain treatment on the income realized, and the decision of the Tax Court should be affirmed.

ARGUMENT

The Taxpayer's Real Estate Subdivision Constituted Property Held By Him Primarily For Sale To Customers In the Ordinary Course of His Trade or Business and Therefore Income Realized From the Sale Thereof Is Ordinary Income

Whether or not the taxpayer is entitled to report as capital gain the income realized by him from the sale of his subdivided homestead property depends upon whether or not such property falls within the definition of a capital asset as set forth by Section 117(a) of the Internal Revenue Code of 1939, *supra.*[1] The section provides in part that—

> (1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade

[1] References to "Code" or "Internal Revenue Code" refer to the Internal Revenue Code of 1939 unless otherwise noted.

> of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or *property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business*, * * * or real property used in the trade or business. (Emphasis supplied.)

The Tax Court found that the taxpayer's real estate was property held "primarily for sale to customers in the ordinary course of his trade or business," and, therefore, in effect, that the property did not constitute a capital asset within the meaning of the statute. This finding of fact, it is submitted, is amply supported both by the evidence and by the holdings in analogous cases decided by this and other courts. In *Friend* v. *Commissioner*, 198 F. 2d 285, 289 (C.A. 10th), it was stated that:

> It is the well settled rule that whether property sold or otherwise disposed of by a taxpayer was held by him for sale to customers in the ordinary course of his trade or business, within the meaning of section 117, is essentially a question of fact. *Rubino* v. *Commissioner*, 9 Cir., 186 F. 2d 304, certiorari denied, 342 U.S. 814, 72 S. Ct. 28; *King* v. *Commissioner*, 5 Cir., 189 F. 2d 122, certiorari denied, 342 U.S. 829, 72 S. Ct. 54; *Mauldin* v. *Commissioner*, *supra*. It is the function of the Tax Court to weigh evidence, draw inferences, resolve conflicts, and determine facts. And a finding of fact made by that Court will not be disturbed on review if it is sustained by substantial evidence and is not clearly wrong. *Helvering* v. *National Gro-*

cery Co., 304 U.S. 282, 58 S. Ct. 932, 82 L. Ed. 1346; *Commissioner of Internal Revenue* v. *Scottish American Investment Co.*, 323 U.S. 119, 65 S. Ct. 169, 89 L. Ed. 113.

The fact that the parties are in substantial agreement as to most of the facts in this case does not change the situation. "It is true that where the facts are not in dispute this court may draw inferences of its own. But the ultimate question is whether the findings are supported by the record." *Rollingwood Corp.* v. *Commissioner*, 190 F. 2d 263 (C.A. 9th). Here the record well supports the findings of the Tax Court.

Before reviewing the evidence presented in this case, it is worthwhile to consider the factual situation in a case which has long been considered a landmark in this area of tax law. *Richards* v. *Commissioner*, 81 F. 2d 369, decided by this Court, is one of the early basic cases determining the status of real property such as that here involved. Interestingly enough, it is not cited by the taxpayer although its facts are exceedingly similar to those at bar. In *Richards*, the taxpayer was engaged in the business of raising and marketing farm products, and in connection therewith purchased various tracts of land. At the time of the purchase the tracts of land lay in a very productive farming area, and the products of adjacent lands, together with the products of the taxpayer's lands, enabled him to make shipments in carload lots. Increased real estate activity in the area, however, soon changed the nature of the land, with the result that the adjacent property began to be subdivided and sold. Taxpayer's property rapidly increased in value, and the rise in prices made the use of the lands for gardening purposes unprofitable. Additionally, the taxpayer was deprived of a base from which to ship his vegetables in carload lots. As a result of these events, the taxpayer decided to subdivide his lands, and appointed an agent to effectuate the subdivision. The taxpayer personally did not take part in either the subdividing or the selling of the lots, and he was not licensed as a broker to buy or sell real estate. The determination of whether or not the income realized from the sale of these lots constituted ordinary income or was a capital gain depended on whether or not the lots were "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." This Court held that the reason for which the lots were "held" rather than the purpose of the original purchase of the land was determinative. It also rejected the taxpayer's contention that the sales constituted liquidation of a capital asset, and accordingly held that the taxpayer was engaged in the business of selling real estate and the income realized therefrom was ordinary income.

The resemblance of the present case to *Richards* is marked. In this case, as in *Richards* the taxpayer was not a real estate broker. The business activites of the taxpayer revolved mainly around his occupation as a cashier in a meat market. It is, however, well settled by *Richards* and other cases that one may have more than one occupation. *Friend v. Com-*

missioner, supra; *Snell* v. *Commissioner*, 97 F. 2d 891 (C.A. 5th); *Oliver* v. *Commissioner*, 138 F. 2d 910 (C.A. 4th); *DiLisio* v. *Vidal*, 233 F. 2d 909 (C.A. 10th). Thus, any reliance the taxpayer places upon the alleged fact that his chief activity was centered at the meat market (Br. 21, 23) is misplaced.

It is also claimed by the taxpayer that he personally did not take an active part in selling the land. (Br. 21, 23.) Neither, however, did the taxpayer in *Richards*. In both instances, the fact that the taxpayer conducted his business through an agent does not serve to make the taxpayer any the less engaged in the business. See *Fackler* v. *Commissioner*, 133 F. 2d 509 (C.A. 6th). The taxpayer maintained control over the actions of the real estate agent in relation to the subdivision in several important aspects. The right to approve any final plan of subdivision was in the taxpayer (R. 43); plans of improvement were to be subject to his approval as to cost (R. 43); the taxpayer and his agent were to agree upon the final prices and terms of sale (R. 44). In addition, the books of account were to be open to the taxpayer's inspection (R. 44) and periodic statements were to be rendered to the taxpayer by the agent (R. 45). It was agreed that the taxpayer was to reimburse the agent for all expenses of preparing the property for sale, including without limitation the cost of surveying, mapping, and improving the property and perfecting title. (R. 43-44.) All payments made by the agent to the engineering company were charged to the taxpayer on the books of the agent. (R. 44-45.) The above enumerated facts clearly negate the contention of the taxpayer that the agent, Samuel W. King, was an independent contractor (Br. 25) and indeed the Tax Court specifically found to the contrary, correctly stating (R. 47), "Nor was King an independent contractor since his major activities were subject to the approval of petitioner." Thus even though the taxpayer himself expended only a minimal amount of time on the subdividing and sale of his lots (compare *DiLisio* v. *Vidal*, *supra*), he was still engaged in the business through the activities of his agent, Samuel W. King.[2] In *Welch* v. *Solomon*, 99 F. 2d 41, 43, this Court said:

> The personal attention which a taxpayer gives to a business is certainly not decisive as to whether a resulting profit is ordinary income or capital gain. One may conduct a business through others, his agents, representatives, or employers. The business is nonetheless his because he chooses to let others bear all of the burdens of management.

See also *Harry P. Gamble, Jr.* v. *Commissioner* (C.A. 5th), decided March 21, 1957.

The Commissioner is willing to concede for the purposes of this argument that the taxpayer did not originally acquire his homestead with the intention of engaging in the business of subdividing and selling it. But the statute by its terms excludes from the definition of a capital asset property "held"

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[2] Compare *Smith* v. *Dunn*, 224 F. 2d 353 (C.A. 5th), where the taxpayer maintained no supervision or control over prices, advertising or activities of the real estate broker.

by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. As this Court pointed out in *Richards*, *supra*, the statute does not read property "acquired" for sale to customers, and to so hold would be to ignore the word "held" in the statute. The important time period for purposes of deciding this particular case is not 1914 when the taxpayer first acquired an interest in the land, nor is it 1923 when he received a land patent deed. The reason for which the land was held *at the time of the sales* is determinative as to whether or not the land was held for sale in the ordinary course of trade or business. And even more, the Commissioner will agree for purposes of argument with the taxpayer's statement (Br. 17) that *if* in 1946 the taxpayer had sold his entire homestead to one buyer without causing it to be subdivided, any gain realized would have been capital gain. But the suppositious "if" of the taxpayer changes the facts sufficiently to completely change the result. Here the taxpayer did not sell his property in one piece. What did he do? He embarked upon a venture which completely changed the character of his property and which completely changed the legal nature of the property so far as the laws of taxation are concerned. He subdivided his property into 33 separate lots, making the necessary improvements,[3]

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[3] The taxpayer's statement that all sales were consummated before any improvements were actually constructed (Br. 21) while correct, is misleading. The stipulation in this case makes it clear that the lots were sold "on the representation that improvements would be constructed." (R. 27.)

surveying and mapping, and perfecting title. He had prepared a plan of subdivision and presented it to the city planing commission for approval. He entered into a contract with an engineering company for the construction of necessary improvements, and paid them $32,000 through his agent. He also paid surveying charges. He had forms prepared for use in connection with the sale of lots, including deposit receipt and contract, deed and mortgage. While neither the taxpayer nor his agent advertised the sale of the lots, the agent maintained a real estate office which indicated that he had property for sale of the type here in question. The picture is clear. By these actions the taxpayer went into the business of selling lots. Such activities were designed, not to liquidate a capital asset,[4] but to get into a high-

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[4] It has by now been made clear that terming the transaction a liquidation of capital assets is not in itself sufficient to change the result. This Court in *Ehrman* v. *Commissioner*, 120 F. 2d 607, 610, certiorari denied, 314 U.S. 668, stated:

> This court has heretofore in *Richards* v. *Commissioner*, 9 Cir., 81 F. 2d 369, 106 A.L.R. 249, and in *Commissioner* v. *Boeing*, 9 Cir., 106 F. 2d 305, rejected the liquidation test in determining whether or not a taxpayer is carrying on a trade or business. In the *Boeing* case, *supra*, 106 F. 2d page 309, we laid down the test: "From the cases it would appear that the facts necessary to create the status of one engaged in a 'trade or business' revolve largely around the frequency or continuity of the transactions claimed to result in a 'business' status." We see no reason for departing from these decisions and now holding that the fact that property is sold for purposes of liquidation forecloses a determination that a "trade or business" is being

priced salable condition a homestead property which had substantially increased in value. That the taxpayer was successful in his endeavors is obvious from the fact that he quickly sold all of the lots in his subdivision except the three which he retained for his own purposes. The asserted fact that it was not necessary for the taxpayer or his agent to put on a hard selling campaign certainly does not change the situation. The seller's market was good, there was a demand for the lots, and it was not necessary to use high pressure methods to sell them.[5] But a rela-

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> conducted by the seller. See also *Welch* v. *Solomon,* 9 Cir., 99 F. 2d 41.
>
> * * * *
>
> The sole question is—were the taxpayers in the business of subdividing real estate?

Compare *White* v. *Commissioner,* 172 F. 2d 629, 630 (C.A. 5th) in which the court stated:

> The gist of the court's holding in the *Farley* case, in which we concur, was that where the liquidation of an asset is accompanied by extensive development and sales activity, the mere fact of liquidation does not preclude the existence of a trade or business; but, where the elements of development and sales activity are absent, the fact of liquidation may not be disregarded.

Even applying the liquidation doctrine of the Fifth Circuit, the taxpayer here would not qualify for capital gains treatment because of his improvements to and development of the land.

[5] Compare *Fahs* v. *Crawford,* 161 F. 2d 315 (C.A. 5th), extensively quoted as authority by taxpayer. In *Fahs,* the taxpayer purchased as an investment a tract of land which was already subdivided. After various schemes to sell the tract en bloc were unsuccessful, he made only those further improvements as ~~was~~ were necessary to make the property salable. In the case at bar the taxpayer has nowhere shown any

tively passive selling policy, if it may even be said that such was the case here, does not in itself rule out the fact that the property was held for sale in the ordinary course of business. *Mauldin* v. *Commissioner*, 195 F. 2d 714 (C.A. 10th). And of course it should be noted that the agent had a real estate office which indicated in itself that he had property of this type for sale.

To summarize, therefore, and as the Tax Court stated in its opinion (R. 47):

> Petitioner chose not to sell the property in the condition in which it was acquired and thus have the benefit of the preferred treatment of capital gains, but to subdivide it and make improvements to reap the benefits of increased selling prices.

Thus the taxpayer resorted to a method of disposal which required that the property be submitted to customers in the ordinary course of a trade or business. See *Palos Verdes Corp.* v. *United States*, 201 F. 2d 256 (C.A. 9th). He clearly is not entitled to capital gain treatment on the gain he has realized.

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efforts on his part to sell his property as a whole nor has he shown that it would have been unfeasible to have so attempted.

CONCLUSION

The decision of the Tax Court was correct and should be affirmed.

Respectfully submitted,

CHARLES K. RICE,
Assistant Attorney General.

ELLIS N. SLACK,
ROBERT N. ANDERSON,
HELEN A. BUCKLEY,
Attorneys,
Department of Justice,
Washington 25, D. C.

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